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TAGS: OECD, ECON, SW
SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC): REVIEW OF THE SWISS ECONOMY

REF: EDR(78)7 AND ADDENDUM

1. SUMMARY: ACCORDING TO OECD SECRETARIAT'S DRAFT SURVEY OF SWISS ECONOMY, STRONG EXPORT DEMAND BOOSTED GDP IN 1977 WELL ABOVE EXPECTATIONS, BUT COMBINATION OF TIGHT FISCAL POLICY AND EXPECTED SLOWDOWN IN EXPORTS DUE APPRECIATION OF FRANC LIKELY TO REDUCE GROWTH IN 1978 TO LITTLE MORE THAN ONE PERCENT. SUCCESS OF STRUCTURAL ADJUSTMENT PROGRAM CONTRIBUTES TO MAINTAINING SWISS INTERNATIONAL COMPETITIVENESS DESPITE STRONG APPRECIATION OF FRANC. SECRETARIAT CONCLUDES THAT MORE EXPANSIONIST FISCAL POLICY INDICATED FOR 1978 TO INSURE MOMENTUM OF ADJUSTMENT PROCESS. MISSION WELCOMES PARTICIPATION OF REP FROM EMBASSY BERN IN SWISS EDRC REVIEW ON MARCH 22
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AND APPRECIATES COMMENTS IN BERN 1242. END SUMMARY

2. RECENT TRENDS: VIGOROUS EXPORT GROWTH AND THE ASSOCIATED MULTIPLIER EFFECTS ON DOMESTIC DEMAND RESULTED IN GDP INCREASE OF 4.3 PERCENT IN 1977, AMONG THE HIGHEST IN OECD. ALL DEMAND COMPONENTS PARTICIPATED, WITH CONSUMPTION UP 2.5 PERCENT IN VOLUME, PARTICULARLY DURABLES,

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FIXED INVESTMENT UP 5 PERCENT FOR MACHINERY AND EQUIPMENT, AND 2 PERCENT FOR CONSTRUCTION, BOTH BUSINESS AND RESIDENTIAL. EXPORTS WERE UP 11.8 PERCENT IN VOLUME, DECELERATING TOWARD THE END OF THE YEAR AS THE FRANC APPRECIATED. IMPORTS WERE UP LESS SHARPLY (10.L PERCENT IN VOLUME, BUT LESS THAN EXPORTS) THUS MAINTAINING A BOT SURPLUS. INDUSTRIAL PRODUCTION ROSE 5.5 PERCENT BUT REMAINED BELOW THE PRE-RECESSION PEAK. THE LABOR MARKET WAS FIRM, CAUSING UNEMPLOYMENT TO FALL TO ABOUT 0.5 PERCENT OF THE LABOR FORCE, ALTHOUGH THE LATTER CONTINUES TO SHOW NO OR NEGATIVE GROWTH. SINCE 1973, TOTAL EMPLOYMENT HAS FALLEN 12 PERCENT, BUT HAS BEEN ABSORBED BY A SHARP REDUCTION IN THE FOREIGN COMPONENT OF THE LABOR FORCE. SWISS PRICES AND WAGES HAVE BY FAR THE BEST PERFORMANCE IN THE OECD AREA, WITH BOTH PRICE AND REAL WAGE INCREASES IN THE NEIGHBORHOOD OF ONE PERCENT FOR THE YEAR. SURPLUS ON CURRENT ACCOUNT (5.5 PERCENT OF GDP, HIGHEST RATIO IN OECD), PLUS EXCELLENT PERFORMANCE ON PRICE, MADE THE FRANC A FAVORED CURRENCY, AS SHOWN BY THE RAPID APPRECIATION IN THE SECOND HALF 1977, AFTER NOMINAL AND EFFECTIVE DEPRECIATION FROM MID-76 TO MID-77. CAPITAL MOVEMENTS SEEM TO HAVE ACCENTUATED THE CURRENT ACCOUNT SURPLUS IN THE SECOND HALF OF 1977 TO CONTRIBUTE TO THE UPWARD PRESSURE. SECRETARIAT CALCULATIONS SUGGEST THAT THE FRANC HAS APPRECIATED FROM 8 TO 20 PERCENT IN REAL TERMS SINCE THE FIRST QUARTER OF
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1973. NEVERTHELESS, SWISS COMPETITIVENESS HAS HELD UP WELL DUE TO A FALL IN UNIT PROFIT MARGINS, THE SPECIALIZATION OF SWISS PRODUCTS AND THEIR GENERALLY-RECOGNIZED QUALITY RESULTING IN LOW PRICE ELASTICITIES.

3. STRUCTURAL ADJUSTMENTS: SECRETARIAT HIGHLIGHTS THREE ASPECTS OF STRUCTURAL CHANGE IN SWITZERLAND SINCE THE 1974 RECESSION. FIRST, DEMOGRAPHIC TRENDS INCLUDING MIGRATION HAVE RESULTED IN A REDUCTION IN THE RESIDENT LABOR FORCE DUE TO OUTMIGRATION AND A FALL IN PARTICIPATION RATES. APART FROM RELIEVING PRESSURE ON LABOR MARKETS AND FACILITATING INDUSTRIAL ADJUSTMENT, THE DEMOGRAPHIC FACTORS HAVE HAD A SIGNIFICANT DEPRESSIVE IMPACT ON THE CONSTRUCTION SECTOR, AS WELL AS OTHER COMPONENTS OF CONSUMER DEMAND SUCH AS CLOTHING. SECOND, THE SWISS ECONOMY IS SUBSTANTIALLY MORE DEPENDENT, IN A STATISTICAL SENSE, ON THE REST OF THE WORLD THAN IT WAS IN 1970. ON THE EXPORT SIDE, THE DEGREE OF DEPENDENCE (EXPORTS AS PERCENTAGE OF GDP) ROSE FROM 35.3 PERCENT TO 42.3 WHILE MOST EUROPEAN COUNTRIES HAVE SEEN

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A DECLINE IN THIS RATIO. FOR IMPORTS, THE COMPARABLE RATIO ROSE FROM 34.5 TO 40.9, OR SOMEWHAT LESS FAST THAN FOR EXPORTS. THIRD, SWITZERLAND HAS BEEN ONE OF THE MOST SUCCESSFUL OF OECD COUNTRIES IN EFFECTING STRUCTURAL CHANGE IN INDUSTRY, THROUGH AN EXTENSIVE PROCESS OF RATIONALIZATION AND REDEPLOYMENT OF PRODUCTION. ADJUSTMENT WAS FORCED ON THE ECONOMY BY THE RAPID APPRECIATION OF THE FRANC, AND THE RESPONSE HAS BEEN EXEMPLARY. LED BY STEPPED-UP RESEARCH AND DEVELOPMENT, THE ADJUSTMENT PROCESS HAS BEEN CHARACTERIZED BY SUBCONTRACTING OF LABOR-INTENSIVE OPERATION ABROAD AND CONCENTRATION DOMESTICALLY ON CAPITAL-INTENSIVE SPECIALIZED PRODUCTS WHICH RETAIN THEIR COMPARATIVE ADVANTAGE DESPITE THE RAPID CHANGES IN THE EXCHANGE RATE. ALTHOUGH THE SECRETARIAT DOES NOT GO INTO DETAIL ON THE THREE ASPECTS OF ADJUSTMENT, THE SECTION IS A USEFUL DESCRIPTION OF THE TYPES OF CHANGE THAT WILL EVENTUALLY HAVE TO CHARACTERIZE THE OECD RECOVERY.

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4. ECONOMIC POLICY: BOTH MONETARY AND FISCAL POLICY CAN BE DESCRIBED AS HAVING BEEN RELATIVELY TIGHT IN 1977, ACCORDING TO THE SECRETARIAT. MONETARY POLICY HAS BEEN BASICALLY COUNTERACTING THE PRESSURES EXERTED BY THE FLOW OF FUNDS ON THE EXCHANGE MARKETS, ACTING TO RELEASE FUNDS IN THE FIRST HALF OF 1977 WHEN AN OUTFLOW WAS OCCURRING THEN REVERSING ROLES TO SOAK UP LIQUIDITY GENERATED BY A STRONG CAPITAL INFLOW IN THE SECOND HALF. APART FROM MEASURES TO RESTRICT INFLOWS, THE MONETARY AUTHORITIES HAVE STERILIZED APPROXIMATELY FRS. 3.45 BILLION IN THE PERIOD OF FEBRUARY, 1978. FISCAL POLICY, PARTIALLY AS A RESULT OF THE JUNE REFERENDUM, WAS MORE RESTRICTIVE IN 1977 THAN 1976, AND IMPARTED A SMALLER STIMULUS TO THE DOMESTIC ECONOMY THAN IN VIRTU-ALLY ANY OTHER OECD COUNTRY. THE SECRETARIAT NOTES THAT THE FAILURE OF THE JUNE REFERENDUM MEANS THAT THE TAX SYSTEM IS STILL HIGHLY INFLEXIBLE AND IN NEED OF REFORM.

5. OUTLOOK FOR 1978: AGAINST A BACKGROUND OF EVEN MORE RESTRICTIVE FISCAL POLICY, UNCHANGED MONETARY POLICY AND A SLACKENING OF THE EXPORT DEMAND DUE TO THE APPRECIA-TION OF THE FRANC, THE SECRETARIAT FORECASTS REAL GDP GROWTH OF 1.5 PERCENT, GIVEN A STRONG CARRYOVER FROM 1977. PRIVATE CONSUMPTION WOULD RISE ONLY MODERATELY AS REAL DISPOSABLE INCOME GROWS LESS THAN 2 PERCENT. CONSTRUCTION IS FORECAST TO FALL 2 PERCENT, ALTHOUGH INVESTMENT IN PLANT AND EQUIPMENT MAY RISE 2 PERCENT. STOCKBUILDING SHOULD BE NEUTRAL OR SLIGHTLY POSITIVE. EXPORTS ARE EXPECTED BY THE SECRETARIAT TO GROW WITH MARKETS; I.E., ABOUT 5.5 PERCENT IN VOLUME, OR ABOUT HALF THE RATE OF 1977. IMPORT VOLUME IS FORECAST TO RISE 6.5 PERCENT, BUT THE VOLUME DEFICIT ON TRADE WILL BE MORE THAN OFFSET BY A FAVORABLE TERMS OF TRADE SWING
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WHICH, WITH A CONTINUED IMPROVEMENT ON INVISIBLES, WILL RESULT IN A LARGER CURRENT ACCOUNT SURPLUS. UNEMPLOYMENT MAY RISE SOMEWHAT IN EARLY 1978 FOR SEASONAL REASONS BUT SHOULD SUBSEQUENTLY FALL. WAGES AND PRICES SHOULD BEHAVE AS IN 1977.

7. CONCLUSION: ON THE BASIS OF ITS ANALYSIS, THE SECRETARIAT SUGGESTS THE FOLLOWING CONCLUSIONS:

(A) A MORE EXPANSIONARY DEMAND MANAGEMENT POLICY, TO BE ACHIEVED MAINLY BY FISCAL MEASURES, COULD HELP TO REDUCE THE CURRENT ACCOUNT SURPLUS AND THEREBY WARD OFF FURTHER EXCESSIVE UPWARD PRESSURE ON THE SWISS FRANC. IT WOULD SEEM DESIRABLE THAT, TO REDUCE THE CONSTRAINTS

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AFFECTING DEMAND MANAGEMENT POLICY IN OTHER MEMBER COUNTRIES, SWITZERLAND SHOULD PLAY ITS PART IN A CONCERTED EFFORT AT INTERNTIONAL LEVEL TO SUPPORT WORLD ECONOMIC ACTIVITY AND ENSURE A BETTER DISTRIBUTION OF THE OECD AREA'S OVERALL DEFICIT.

(B) A MORE SUSTAINED GROWTH IN ACTIVITY AND A REDUCTION IN UPWARD PRESSURE ON THE SWISS FRANC WOULD MAKE IT EASIER TO PUSH ON FURTHER WITH THE RESTRUCTURING OF INDUSTRY ACHIEVED DURING THE LAST FEW YEARS.

8. MISSION COMMENTS:

(A) SWISS ECONOMY SEEMS TO BE DOING EXCEPTIONALLY

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WELL IN ADJUSTING TO ECONOMIC SHOCKS OF EARLY 70'S AND TO STEADY DETERIORATION OF COMPETITIVE POSITION MEASURED IN TERMS OF REAL EXCHANGE RATE MOVEMENTS. SECRETARIAT OUTLINES HOW SOME OF THE STRUCTURAL CHANGES HAVE OCCURRED, BUT IS WEAK ON WHY, AND PARTICULARLY THE POLICY ACTIONS WHICH MAY HAVE FACILITATED A POSITIVE ADJUSTMENT PROCESS. MISSION EXPECTS THIS TO BE PRINCIPAL TOPIC OF EDRC DISCUSSION, AND HOPES EMBASSY BERN

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REP CAN PROVIDE ANALYSIS OF STRUCTURAL ADJUSTMENT PROCESS IN SWITZERLAND FROM U.S. POINT-OF-VIEW.

(B) ALTHOUGH MOST OECD COUNTRIES HAVE LOW CAPACITY UTILIZATION RATES, THEY ALSO HAVE SIGNIFICANT OPEN OR HIDDEN UNEMPLOYMENT SO THAT CAPITAL STOCK IS INSUFFICIENT TO FULLY EMPLOY SUPPLY. SWISS CASE SEEMS TO BE OPPOSITE, I.E., LABOR WOULD BE CONSTRAINING FACTOR IN SUSTAINED DEMAND RECOVERY. U.S. DEL PLANS TO EXPLORE THIS IDEA WITH SWISS DELEGATION, WITHOUT DIRECTLY ADDRESSING IMMIGRATION POLICY.
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(C) SECRETARIAT NOTES THAT SWISS LONG-TERM CAPITAL OUTFLOWS FELL IN 1977, PUTTING FURTHER UPWARD PRESSURE ON FRANC. HIGHER LEVELS OF AID TO DEVELOPING COUNTRIES WOULD SEEM TO BE APPROPRIATE AND DESIRABLE IN THIS REGARD, EVEN GIVEN WELL-KNOWN POLITICAL CONSTRAINTS. MISSION PLANS TO RAISE THIS POINT IF NEGLECTED BY OTHER DELS.

(D) SECRETARIAT HAS QUITE DIRECTLY URGED MORE EXPANSIONARY FISCAL POLICY IN SWITZERLAND. MISSION PLANS TO SUPPORT GENERAL LINES OF THIS RECOMMENDATION.

(E) DRAFT SURVEY AT ONE POINT SAYS QUOTE THE SWISS FRANC'S APPRECIATION IN THE SECOND HALF OF THE YEAR SEEMS TO HAVE BEEN DUE TO SOME WIDENING OF THE CURRENT SURPLUS AND UPWARD PRESSURES CREATED BY CAPITAL MOVEMENTS WHEN THE INTERNATIONAL EXCHANGE MARKETS BECAME UNSETTLED, NOTABLY BY THE SHARP FALL OF THE DOLLAR. DURING THAT PERIOD THE CENTRAL BANK HAD TO INTERVENE FOR VERY LARGE AMOUNTS ON THE EXCHANGE MARKET. UNQUOTE. MISSION PLANS TO ASK SECRETARIAT TO CHANGE WORDING ON THIS POINT TO BETTER REFLECT "DISCRETIONARY" NATURE OF EXCHANGE MARKET INTERVENTION.
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